The Pakistan Credit Rating Agency Limited

Rating Report

Descon Oxychem Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
01-Jul-2020	A	A1	Positive	Maintain	-
02-Jul-2019	A	A1	Positive	Maintain	-
31-Dec-2018	A	A1	Positive	Maintain	-
30-Jun-2018	A	A1	Stable	Maintain	-
30-Jun-2017	A	A1	Stable	Maintain	-
22-Sep-2016	A	A1	Stable	Maintain	-
11-Dec-2015	A	A1	Stable	Maintain	-
12-Dec-2014	A	A1	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The ratings recognize Descon Oxychem's leading position in the local Hydrogen Peroxide (HPO) market, supplemented by efficient production processes, sound technological infrastructure and effective control environment. One of the only two manufacturers in Pakistan's market, Descon Oxychem has gradually strengthened its footprint; particularly in the North region. The recent upturn in global HPO prices accompanied by Pakistan Rupee devaluation has impacted the Company's profitability positively. However, since COVID-19 outbreak and subsequent lockdown, HPO prices have gone down despite further rupee devaluation due to lower demand, especially from the textile sector. Demand from textile is expected to remain low despite eventual easing of lockdown and resumption of operations. The Company managed to sustain its revenue during these challenging times through product diversification. The Company has introduced multipurpose disinfectant / sanitizer products to support its business profile. Meanwhile, the financial risk profile remains strong characterized by efficient working capital management and strong coverages. The Company has converted long term loan obtained for an associated company into ordinary shares resulting in improved leveraging. Leveraging may go up once expansion project related borrowings are obtained but will remain manageable. Ratings further draw comfort from Descon Oxychem's association with a financially sound and experienced business group - DESCON - which has continuously demonstrated support.

The ratings are dependent on improved competitiveness of the Company through product diversification to mitigate slowdown in demand. Timely execution of the expansion plan and translation of the same into better profitability would positively impact the ratings. Meanwhile, smooth operations from the current plant would remain important. Maintaining strong coverages and sustainable leveraging will remain critical.

Disclosure	
Name of Rated Entity	Descon Oxychem Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Chemical(Jun-19)
Rating Analysts	Bakhtawar Abid | bakhtawar.abid@pacra.com | +92-42-35869504

Profile

Legal Structure Descon Oxychem Limited (Descon Oxychem) is a public limited concern incorporated in 2004 listed on Pakistan Stock Exchange.

Background Descon Oxychem was incorporated as a private limited company and was listed in September, 2008. It is a project of the Descon Group. Following commissioning in October 2008, the Company's plant started commercial production in March 2009.

Operations The main business of Descon Oxychem is the manufacture and distribution of Hydrogen Peroxide (HPO) up to 60% concentration. Its production facility is located at 18 Km Lahore Sheikhupura Road consisting of an HPO plant with a capacity of 28,000 MT per anum and a Hydrogen plant.

Ownership

Ownership Structure In 9MFY20 after converting long term debt into equity, the principal sponsor of Descon Oxychem now holds majority shareholding ~73.56 % through associated companies while 26.44% stake rests with the general public and financial institutions.

Stability The transfer of the Company's ownership to a holding company provides clarity to Descon Oxychem's ownership structure, boding well for its stability.

Business Acumen Descon Oxychem has been operating in engineering, chemicals and power as its core businesses since 1977. Mr. Abdul Razak Dawood, current Advisor to the Prime Minister for Commerce, Textile, Industry and Production, is founder and former Chairman of the Descon Group. The Razak Dawood Family is one of the well-known business families of the Country.

Financial Strength The Descon Group has expanded its footing in diversified business avenues with a sizable portfolio of strategic investments, enhancing the Group's financial strength. The Group has shown willingness and ability to support the Group companies in times of need.

Governance

Board Structure Descon Oxychem's Board comprises eight-members comprising one executive director, four non-executive, and three independent members. The Board structure is considered strong.

Members' Profile Descon Oxychem's Board comprises highly qualified members and has a blend of business studies, engineering and finance professionals. Mr. Taimur Dawood, Chairman, leads the Board with over 15 years of work experience in diversified sectors.

Board Effectiveness Strong attendance of Board members in Board meetings and proper documentation of minutes bodes well for the Board's effectiveness. Further, four Board committees have been formed to assist the Board.

Financial Transparency A.F. Ferguson & Co., listed in Category "A" of the State Bank's panel of auditors, is the external auditor of the Company. They expressed an unqualified opinion on the Company's financial statements for June 2019 and December 2019. Meanwhile, the Company has outsourced its internal audit function to KPMG Taseer Hadi & Co.

Management

Organizational Structure The Company operates through seven functional departments, each headed by an experienced manager. Some business functions including IT, Human Resources and Accounting & Finance are shared at Group level.

Management Team Mr. Imran Qureshi is the current CEO of Descon Oxychem, with overall 20 years of experience in the textile, chemical and paints sectors. He is assisted by an experienced and professional management team.

Effectiveness Descon Oxychem's senior management receives daily performance reports of the plant's operations which results in optimal monitoring. Key management personnel meet on a daily and weekly basis to discuss key issues, reflecting well on the management's effectiveness.

MIS The Company has implemented the R12 version of the Oracle E-business suite application, which is also used at other associated companies of Descon. The ERP solution generates various MIS reports related to production, inventory management, sales and trade receivables/payables, resulting in increased efficiency.

Control Environment The Company's HPO plant was supplied by Chematur Engineering, Sweden; regular visits by Chematur's staff also ensure efficient operations and high quality of the final product. Descon Oxychem has been given the license to be the sole operator of Chematur technology in Pakistan. Descon Oxychem has implemented Quality hygiene Safety Model and Reliability Centre Management which helps in improving plant reliability.

Business Risk

Industry Dynamics Pakistan's HPO industry presently comprises two players: Descon Oxychem and Sitara Peroxide with an installed capacity of 28,000 MT and 30,000 MT respectively. Currently, the domestic demand outstrips the supply and is estimated at ~69,500 MT. Hence, ~15-20% of demand is met through imports. Going forward, Engro Polymer and Chemicals is entering the HPO industry with 20,000 MT capacity. Anti-dumping duties have been imposed on multiple international players. Due to COVID-19 Oubtreak and subsequent lockdown, the HPO prices and demand has gone down impacting the performance of the players.

Relative Position Presently, Descon Oxychem remains the HPO market leader with a market share of ~51%. With Engro Polymer and Chemicals' new plant, the Company's market share may diminish, going forward. However, with continually rising local demand and capacity expansion underway, Descon Oxychem is expected to remain the leading player.

Revenues During 9MFY20, the topline of the Company has slightly increased by ~2% YoY, amounting to ~PKR 2,087mln (9MFY19: ~PKR 2,039mln) which majorly comprises textile grade. However, the Company recorded minimum growth due to the outbreak of COVID-19. Despite lower demand, the Company managed to sustain its sales. Moreover, the impact of this pandemic will impact the sales volume and lower sale are expected in the last quarter of FY20.

Margins Descon Oxychem's gross margin showed slight YoY deterioration in 9MFY20, amounting to ~28.7% (9MFY19: ~33.9%) due to a simultaneous increase in production cost as gas prices increased due to the shift to RLNG instead of natural gas. The same translated into the decreased operating profit margin (9MFY20: ~23.2%, 9MFY19: ~28.2%). Meanwhile, finance cost decreased during the period since the Company has reduced the reliance on short term borrowings and the Company has also converted its long term loan obtained for the associated company into ordinary shares due to which finance cost decreased by ~67%. This also led the bottom line to grow, amounting to ~PKR 269mln (9MFY19: ~PKR 232mln).

Sustainability Descon Oxychem regularly invests in BMR. Optimal capacity utilization is of utmost importance to enable the Company to manage its costs and sustain high margins. However, the COVID-19 outbreak has adversely affected the textile sector which contributes significantly to business revenues. Amid COVID-19 pandemic the Company not only has to face the financial challenges but also has to maintain its margins and profits. However, the introduction of SaniDol and CareOx is part of revenue diversification strategy which is likely to mitigate the impact of Textile downturn.

Financial Risk

Working Capital Descon Oxychem's cash cycle remains robust as nearly all sales are on a cash basis while the Company is offered a credit period of 90 days by its sourcing partners. Over the years, working capital management has improved which is evident from the continuous reduction in the net cash cycle. Most of the Company's sales are cash-based, resulting in a very short net cash cycle which has improved over the years (9MFY20: 1 day, 9MFY19: 8 days). A significant borrowing cushion has been sustained by the Company (9MFY20: 58%, 9MFY19: 53%) YoY owing to minimal dependence on short-term borrowings.

Coverages Descon Oxychem witnessed a YoY decline of ~26% in its operational cash flows during 9MFY20, mainly due to lower profitability. Coverages, however, improved YoY owing to lower finance cost. The Company's interest coverage clocked in at 6.8x in 9MFY20 (9MFY19: 2.3x) similarly, core debt coverage amounted to 6.8x (9MFY19: 1.9x).

Capitalization Descon Oxychem's leveraging has decreased significantly over the years. Leveraging decreased to ~10.5% in 9MFY20 (9MFY19: ~57.7%). Short-term borrowings comprise only ~6% of the total borrowings of the Company as the Company has reduced the reliance on short term borrowings and the Company has also converted its long term loan obtained for the associated company into ordinary shares capital. However, going forward Company will finance for the expansion project which will cost approx. PKR 1.25bln & approx PKR 895mln will be financed through the Long term debt.

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Financial Summary
PKR mln

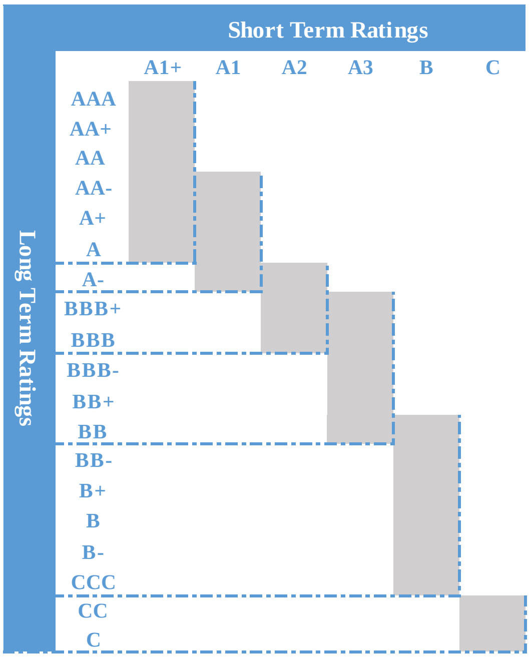
Descon Oxychem Limited Chemicals	Mar-20 9M	Jun-19 12M	Jun-18 12M	Jun-17 12M
A BALANCE SHEET				
1 Non-Current Assets	1,618	1,531	1,455	1,625
2 Investments	-	-	-	-
3 Related Party Exposure	-	-	-	-
4 Current Assets	860	717	585	535
a Inventories	*151*	*72*	*26*	*48*
b Trade Receivables	*60*	*81*	*39*	*67*
5 Total Assets	2,478	2,248	2,039	2,160
6 Current Liabilities	304	327	263	401
a Trade Payables	*167*	*175*	*90*	*85*
7 Borrowings	207	269	-	42
8 Related Party Exposure	3	736	1,100	1,100
9 Non-Current Liabilities	179	133	-	-
10 Net Assets	1,787	784	676	617
11 Shareholders' Equity	1,787	784	676	617
B INCOME STATEMENT				
1 Sales	2,087	2,705	2,088	1,961
a Cost of Good Sold	*(1,487)*	*(1,874)*	*(1,472)*	*(1,454)*
2 Gross Profit	600	831	616	507
a Operating Expenses	(116)	(127)	(152)	(152)
3 Operating Profit	484	703	465	354
a Non Operating Income	*(22)*	*(43)*	*(6)*	*(9)*
4 Profit or (Loss) before Interest and Tax	462	661	459	345
a Total Finance Cost	*(77)*	*(267)*	*(269)*	*(12)*
b Taxation	*(115)*	*(184)*	*(132)*	*(129)*
6 Net Income Or (Loss)	269	210	58	205
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*516*	*711*	*591*	*541*
b Net Cash from Operating Activities before Working Capital Changes	*412*	*646*	*394*	*261*
c Changes in Working Capital	*(77)*	*(34)*	*54*	*(44)*
1 Net Cash provided by Operating Activities	334	612	449	217
2 Net Cash (Used in) or Available From Investing Activities	(207)	(312)	(51)	(52)
3 Net Cash (Used in) or Available From Financing Activities	49	(382)	(306)	(364)
4 Net Cash generated or (Used) during the period	176	(82)	91	(200)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	2.9%	29.5%	6.5%	24.0%
b Gross Profit Margin	28.7%	30.7%	29.5%	25.8%
c Net Profit Margin	12.9%	7.8%	2.8%	10.4%
d Cash Conversion Efficiency (EBITDA/Sales)	28.7%	31.3%	29.9%	28.0%
e Return on Equity (ROE)	27.9%	28.8%	9.0%	39.8%
2 Working Capital Management				
a Gross Working Capital (Average Days)	24	15	16	19
b Net Working Capital (Average Days)	1	-3	0	4
c Current Ratio (Total Current Assets/Total Current Liabilities)	2.8	2.2	2.2	1.3
3 Coverages				
a EBITDA / Finance Cost	7.9	3.2	2.3	68.4
b FCFO / Finance Cost+CMLTB+Excess STB	6.8	2.7	2.2	67.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	0.3	2.0	3.4	2.1
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	10.5%	56.2%	62.0%	64.9%
b Short-Term Borrowings / Total Borrowings	0.1	0.1	0.0	0.0
c Average Borrowing Rate	16.6%	24.8%	23.8%	0.6%

Credit Rating Scale & Definitions

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings	
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings	
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
Proprietary Information